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Supreme Court, U.S.
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No. 04-198

IN THE

Supreme Court of the United States

R.J. FITZGERALD & CO., INC., RAYMOND FITZGERALD, AND LEIZA FITZGERALD,

Petitioners,

v.

COMMODITY FUTURES TRADING COMMISSION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

REPLY IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

MONTGOMERY N. KOSMA
Counsel of Record
MICHAEL A. CARVIN
MARY BETH YOUNG
JONES DAY
51 Louisiana Avenue NW
Washington, DC 20001
(202) 879-3939

CONSTANTINE JOHN GEKAS
GEKAS & ASSOCIATES, LTD.
11 South LaSalle Street, #1700
Chicago, IL 60603
(312) 726-4501

Counsel for Petitioners

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

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REPLY IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

The CFTC's Brief in Opposition ("Opp.") trivializes the important issues raised in this case. It attempts to deny the existence of a circuit split on whether an objective or subjective standard applies in assessing the existence of scienter for commodities and securities fraud. It then deems the distinction merely "metaphysical." Opp. 17. The CFTC ignores the reality that the Commission's own most recent decision on scienter *contradicts* both the arguments it offers this Court and the majority opinion of the court of appeals. The split of authority is real and significant, and merits resolution by this Court.

Similarly, the CFTC fails to acknowledge the troubling questions raised by the court of appeals' determination that petitioners' speech was misleading. By conducting a *de novo* review of the bare text of the promotions and concluding they were "unbalanced" and misleading as a matter of law, the panel decision introduces serious uncertainty regarding the proper mode of analyzing whether speech is misleading.

Finally, in light of the CFTC's efforts to portray petitioners' promotions as "obviously" misleading, and thus "demonstrat[ing] scienter under any plausible standard," Opp. 7, it bears recalling the basic posture of this case. The decision below finds petitioners guilty of commodities fraud as a matter of law on the basis of speech (1) that was concededly truthful, (2) that they believed was not misleading in good faith and after reasonable inquiry, and (3) that two of the four judges to consider the issue agreed was not misleading.

These circumstances hardly present an "obvious" instance of fraud; in fact, they present a situation in which imposing fraud liability raises serious First Amendment concerns.[1] As

[1] Although there is a substantial government interest in preventing fraud, this Court has also recognized that fraud cases generally impose "[e]xacting proof requirements ... to provide sufficient breathing room

Circuit Judge Wilson's dissent cautioned (Pet. App. 44a):

> Commodities brokerage firms should be on the alert – this decision may make it difficult to advertise and solicit business in the future. It is uncertain what subsequent advertising language may "overemphasize profit and downplay risk of loss."

I. THE COURT SHOULD RESOLVE THE SPLIT AS TO WHETHER SUBJECTIVE CULPABILITY IS NECESSARY FOR COMMODITIES FRAUD

The CFTC commits serious error in its Opposition, blinding itself to a clear circuit split by resorting to strained or superficial treatment of all the key decisions. The CFTC sees an "identical legal standard" among the circuits, Opp. 7, while ignoring the numerous commentators who identify confusion in this supposedly uniform body of law. For example, the leading commodities law treatise states that "the wealth of decisions regarding intent in fraud cases ... offer solace for nearly every possible formulation." 2 Philip Johnson & Thomas Hazen, *Commodities Regulation* § 5.08[1], at 5-91 (3d ed. 2003). *See also* Pet. 9 n. 2.

There is little to the CFTC's superficial observation that cases on both sides of the circuit split refer to the *Sundstrand* language defining recklessness as "an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977). Contrary to the CFTC's suggestion, the petition does not characterize *Sundstrand* as an objective recklessness case. Opp. 10. Rather, it explains that

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for protected speech." *Illinois ex rel. Madigan v. Telemarketing Assocs.*, 538 U.S. 600, 620 (2003).

Sundstrand is ambiguous, lending support to either an objective or subjective formulation, and that ambiguity is a substantial cause of the circuit split. Pet. 14-15. As one commentator has observed, despite "widespread adoption of language from *Sundstrand* ... , *scienter and recklessness are still subject to varying interpretations.*" William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 Hous. L. Rev. 121, 122 (1997) (emphasis added). *Sundstrand* suggests that an obvious danger of misleading customers can support an inference of subjective recklessness, but certainly does not require the position that such an inference is mandatory, or even permissible in the presence of findings that the actor in fact did not appreciate the danger.[2]

Indeed, the First, Fifth, Ninth, and D.C. Circuits and the CFTC itself, while using language paralleling *Sundstrand*, plainly adopt subjective standards that *do* require evidence or inference of the defendant's actual state of mind.

The Ninth Circuit holds that section 4c of the Commodities Exchange Act requires proof "that [defendant's] acts [were] done with knowledge of their nature and character." *CFTC v. Savage*, 611 F.2d 270, 282-83 (9th Cir. 1980) (holding summary judgment improper because "appellant's intent and knowledge are particularly within his personal comprehension"). The CFTC's attempt to distinguish *Savage* confines its discussion to the *wrong* portion of the opinion. *See* Opp. 11-12 (addressing "concert" under § 4b but ignoring that *Savage* applied the same test under § 4c).[3]

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[2] The CFTC is wrong that the trial court "made no specific findings on recklessness." Opp. 19 n.6. The trial court's conclusions of law stated that scienter could be established if a defendant "acted with careless disregard of whether his actions violated the Act," but found "no evidence that Raymond Fitzgerald was aware of any violations and recklessly or intentionally failed to remedy any violations." Pet. App. 66a, 53a.

[3] Tellingly, the Commission itself defines "reckless disregard" under § 4c(b) and Rule 33.10 by quoting the test from *Savage*. *See infra* at 5.

Nor can the majority's decision be reconciled with *SEC v. Steadman*, 967 F.2d 636 (D.C. Cir. 1992). In *Steadman* one defendant was a Harvard Law graduate and all defendants had extensive securities industry experience. The district court found scienter based on objective recklessness, because "it should have been obvious to such people that the advice they received from [their lawyer] was wrong." *Id.* at 642. The D.C. Circuit reversed, holding such obviousness inadequate to establish that any defendant "actually knew the opinion was wrong or was reckless in relying on it." *Id.*

Moreover, the D.C. Circuit later explained that *Steadman* contradicts the very position adopted by the majority below. It "misreads precedent – particularly *Steadman* – ... to conclude that the concept of reckless disregard which meets the subjective standard is satisfied by merely showing an extreme departure from standards of ordinary care." *Saba v. Compagnie Nationale Air France*, 78 F.3d 664, 669 (D.C. Cir. 1996). Here, the majority's analysis asserts only that petitioners "departed in an extreme manner from the ordinary standards of care." Pet. App. 15a, 19a. This approach reduces scienter to "nothing more than gross negligence," *Saba*, 78 F.3d at 669 – contravening this Court's ruling in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

The CFTC's discussion of the other circuits is equally unavailing. It identifies no First or Fifth Circuit case that contradicts the decisions of those circuits defining scienter as "an essentially *subjective* state of mind" that "*must actually exist in the individual* making ... the representation." *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (emphasis added); *see also* Pet. 12-13. The CFTC raises *SEC v. Fife*, 311 F.3d 1 (1st Cir. 2002), but mischaracterizes that case as finding scienter based on objective evidence. In *Fife*, defendants agreed not to invest a customer's money without his consent. One defendant claimed he was unaware of the agreement to this effect, but his testimony was contradicted by evidence of a letter

showing that he "was at least aware of some of the Agreement's terms." *Id.* at 10. Based on this evidence of actual knowledge, the First Circuit affirmed the district court's finding of scienter. *Id.*

The Commission's own decision in *Staryk* contradicts the basic premise of the opposition, squarely recognizing the significant difference between an objective and subjective test, and adopting the latter. The Commission affirmed the ALJ's ruling that Staryk's speech was "blatantly false," but "remand[ed] for a hearing on the issue of scienter" because the ALJ erred *as a matter of law*:

> While the deceptive nature of Staryk's solicitations was determined according to an objective standard, his intent in making those representations is a subjective question.

In re Staryk, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,206, 1997 WL 778236, at *4, *7-*10, *12 (CFTC Dec. 18, 1997) ("*Staryk I*"). It held that scienter so depends upon "oral testimony" and "reliably assessing ... credibility" that "Staryk will be prejudiced if his state of mind is determined against him without an opportunity for him to appear in person before a trier of fact." *Id.* at *12.

The CFTC barely discusses *Staryk*, and worse: it fails to disclose its own Summer 2004 decision that elaborates the distinction between the proper subjective test and that applied here by the court of appeals. *In re Staryk*, No. 95-5, 2004 WL 1657544 (CFTC July 23, 2004) ("*Staryk II*").[4] Citing its own prior decisions – including those discussed at Opp. 15-16 – as well as decisions of the Ninth and D.C. Circuits, the Commission defined "reckless disregard" under § 4c and Rule 33.10 as acts "done with knowledge of their nature and character." *Id.* at *9. The Commission validated

[4] This decision was issued a few days before the petition for certiorari was filed in this case, but petitioners did not learn of it until recently. Although *Staryk II* is directly on point, the CFTC did not mention the decision in its opposition despite receiving two extensions to file its brief.

the ALJ's formulation: "credible testimony ... that [Staryk] possessed a good faith belief that he was not misleading customers (no matter how rash he was in its formulation) would preclude a finding of fraud." *Id.* at *5. (And remember, Staryk's speech was already held not just misleading but *blatantly* false.) Although Staryk failed to establish clear error in the ALJ's evaluation of his testimony and demeanor, the Commission criticized the ALJ for characterizing "Staryk's testimony about his personal, educational and employment background, as well as ... firm compliance practices" as "at best tangential" to the issue of scienter. *Id.* at *10 n.22. To the contrary, "[s]ome or all of these factors may lend credence to a respondent's claim of good faith." *Id.* Specifically, Staryk's testimony would have had more weight had he specified which "attorneys and ... compliance officials" had provided advice, "what they told him, or what basis he had for believing their advice to be accurate." *Id.*

It is impossible to reconcile this treatment of scienter with the objective test adopted by the Eleventh, Second, and Sixth Circuits. These courts hold that a defendant's subjective state of mind is irrelevant once objectively reckless conduct is established. *See* Pet. 16-17.

This clear circuit split is no mere "metaphysical" dispute. This Court has recognized the important distinction between objective and subjective tests for *mens rea* in other contexts. *Farmer v. Brennan*, 511 U.S. 825, 836 (1994) (holding that "recklessness is not self-defining" and that an objective test cannot serve as a proxy for intent). Indeed, the Court essentially equated the objective formulation of recklessness advocated here by the CFTC – one based on a risk "so obvious that it should be known," *id.* – with "gross negligence," the very standard rejected by this Court as a basis for securities fraud in *Hochfelder*. It is *not* "quibbling" to debate the meaning of objective versus subjective recklessness. *McGill v. Duckworth*, 944 F.2d 344, 348 (7th Cir. 1991). Indeed, the difference between an objective and subjective test is the

"key divide ... between a means of imposing liability that requires a showing of intent and one that does not." *Saba*, 78 F.3d at 669 (footnote omitted).

This difference is outcome determinative here and in many other cases. Had this case been brought in the Ninth or D.C. Circuit, or before a CFTC ALJ instead of in federal district court, the trial court's judgment of no liability would have been affirmed. Similarly, had this case or *Savage* or *Steadman* been brought in the Second, Sixth, or Eleventh Circuit, fraud liability likely would have been imposed. The distinction is also important in terms of the procedural protections to which a defendant is entitled. In the Eleventh Circuit and other courts applying an objective test, Staryk would not have been entitled to a hearing, and thus – in the Commission's own words – would have been "prejudiced" by having "his state of mind ... determined against him without an opportunity for him to appear in person before a trier of fact." *Staryk I*, 1997 WL 778236, at *12. Petitioners will likewise be prejudiced, absent this Court's intervention.

The CFTC also says that this split of authority should be resolved not here but in a securities case. It offers no basis to believe that the standards are different in the two contexts. *Cf. Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 389 n.88, 394 (1982) (explaining that the fraud provisions of the commodities laws are "analogous" to Rule 10b-5). If the standards *are* different, waiting for a securities case of course does nothing to resolve the conflict among commodities fraud cases. Commodities fraud is of unquestionable importance in its own right, and any suggestion to the contrary is a peculiar argument coming from the agency that oversees the nation's commodities markets.

II. THE ELEVENTH CIRCUIT'S ANALYSIS OF WHETHER THE PROMOTIONS WERE MISLEADING REQUIRES REVIEW

The CFTC rewrites then does not respond meaningfully to

the second Question Presented: whether the court of appeals applied an improper standard of review in assessing whether petitioners' speech would mislead a reasonable listener. This issue is not a "record-based assertion" regarding the facts in this case. Opp. 21. Instead, it involves the basic methodology for determining whether speech is misleading. If the opinion below is correct, a trial court faced with an allegedly misleading promotion can spare itself a trial and simply read the text of the promotion. (And an appellate court, in turn, can do the same.) The Court's guidance is warranted in order to instruct lower courts on whether this approach is appropriate.

The petitioners' promotions were not "obviously" misleading, if even misleading at all. Certainly, there was no basis to meet the high threshold established by this Court for resolving such questions against petitioners "as a matter of law." *See, e.g., TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) (noting that the underlying facts are "merely the starting point" for determining "the inferences a 'reasonable [person]' would draw from a given set of facts"); *see also* Pet. 24. There is no genuine dispute:

- That all the representations at issue were truthful and supported by the firm's actual results. Even a CFTC witness admitted that he turned a $9,000 investment into $27,000 in under four months. R32 at 1477-79 (Judge Scriven noting that "the only evidence we have … establishes that certainly it is possible to [earn profits of 200 to 300 percent] in the commodities market if you bet right").
- That Magistrate Judge Scriven and Circuit Judge Wilson believed these promotions included sufficient risk disclosures and were not misleading. So did the legal compliance department of Iowa Grain (which was independently interested in ensuring compliance given that it was strictly liable for any violations by RJFCO).
- That the commercial contained substantial risk disclosures, as Judge Wilson described at length. Pet. App. 33a-

35a. For example, for 45 seconds a bold message appeared right above the firm's phone number, stating "OPTIONS INVESTING INVOLVES A RISK OF LOSS. MINIMUM ACCOUNT $5,000." Pet. App. 34a. In the middle of the commercial, the voice-over dropped in tone and stated that "option investing involves a high risk of loss and only risk capital should be used." Pet. App. 35a. As Judge Wilson asked, "How much more warning is required than a disclosure that the investment is a '*high risk*'?" Pet. App. 35a.

- That the seminar contained similarly substantial risk disclosures, and its illustrations mirrored those used in publications by industry regulators. Pet. App. 35a-37a. Judge Wilson explained the similarity between RJFCO's statements and those found in the National Futures Association (NFA) manual. Pet. App. 36a.[5] Even a CFTC witness admitted that the risk of loss had been disclosed to her at the seminar, Pet. App. 69a.

- That the promotions claimed almost exactly the *opposite* of what the CFTC asserts, representing truthfully that weather is inherently *un*predictable; that dramatic weather events can give rise to profit opportunities; and that El Niño increased the likelihood that such a dramatic event might occur in the coming months. *See* Pet. App. 78a-79a (holding that "the evidence establishes clearly that no one knew for sure what [El Niño's] effects were going to be in the market"). *See also* Pet. App. 30a-31a (explaining that petitioners focused on market effects of unexpected phe-

[5] Contrary to the CFTC's contention that "the record does not support" this point, Opp. 22 n.9, the trial court made express findings that were not challenged by the CFTC on appeal. Pet. App. 69a; *see also, e.g.*, Br. for Appellees to 11th Cir., tab D at 18 (DX235-18) (NFA illustration showing a $950 call option liquidated for $2,500). The CFTC's own brief cites Mrs. Fitzgerald's testimony that she essentially "plagiarized" the seminar's statements and illustrations from the NFA and CBOT. R41-2296 (cited in Opp. 22 n.9).

nomena, not predictable trends).[6] Judge Wilson clearly explained that these representations are entirely unlike any previously held unlawful. Pet. App. 27a-30a.

- That Petitioners never "misrepresented the firm's track record or lied about successes in the past." Pet. App. 42a-43a. Yet every case cited by the CFTC imposing a duty to disclose a trading record did so based on the nexus between that information and representations about past successes.

In light of the foregoing, it is plain that the Eleventh Circuit could only find petitioners' speech misleading (much less "obviously" misleading) by virtue of a cursory, non-deferential review. The CFTC claims the Eleventh Circuit did consider at least some selected "contextual" evidence, Opp. 21, but does not and cannot claim that the court of appeals properly addressed any of the trial court's factual findings and reversed them as clearly erroneous under Rule 52. Instead, the court of appeals ignored the trial court's findings, and based on the bare text of the promotions, deemed them misleading "as a matter of law." Thus, this Court need not enmesh itself in the facts surrounding the promotions in order to conclude that the court of appeals conducted a superficial and improper *de novo* review in reaching its conclusion that petitioners' speech was misleading.

CONCLUSION

The petition for a writ of certiorari should be granted.

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[6] *See also, e.g.*, Chicago Board of Trade, *Weather and the Corn Market* at 2 (DX119-2) ("It doesn't take a veteran trader to understand that adverse weather, be it frost or too little or too much rain, can seriously tip the balance between supply and demand, creating … significant trading opportunities for the attentive investor.").

Respectfully submitted,

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MONTGOMERY N. KOSMA
Counsel of Record
MICHAEL A. CARVIN
MARY BETH YOUNG
JONES DAY
51 Louisiana Avenue NW
Washington, DC 20001
(202) 879-3939

CONSTANTINE JOHN GEKAS
GEKAS & ASSOCIATES, LTD.
11 South LaSalle Street, #1700
Chicago, IL 60603
(312) 726-4501

Counsel for Petitioners